The disclosure decisions concerning Fastow's interest in the LJM transactions were also made without the key participants knowing the amount—or even the magnitude—of the interest in question. This is because no one—not members of Senior Management (such as Lay, Skilling or Causey), not the Board, and not Vinson & Elkins—ever pressed for the information, and Fastow did not volunteer it.[85/] The amount of the interest should have weighed in the disclosure decision. Senior Management apparently permitted Fastow to avoid answering the relevant portion of the questionnaires designed to collect information from all executives and directors for the proxy statement disclosures. In 2000, Fastow responded to the questionnaire by attaching an addendum at the suggestion of the lawyers referring the reader to the then-General Counsel of Enron Global Finance for information on Fastow's interests in LJM1 and LJM2. In 2001, Fastow attached an addendum approved by in-house and outside counsel saying only that "the nature of my relationship between LJM1 and LJM2 (including payments made, or proposed to be made, between such entities and Enron) are [sic] described in the Company's 1999 and 2000 Proxy Disclosure under 'Certain Transactions.'"

Descriptions of the Transactions. Item 404(a) of Regulation S-K also requires a description of the related-party transactions in which the amount of the transaction exceeds $60,000 and an executive has a material interest. All of Enron's transactions

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85/ As we have explained (see Section VII.A.), the Finance Committee of the Board in October 2000 asked the Compensation Committee to review the compensation received by Fastow from the LJM partnerships. This request reflected a recognition that the compensation information was important for the Board and management to know, but the review apparently was not conducted.

with the LJM partnerships discussed in this Report met this threshold and had to be disclosed.

For the most part, the Company's proxy statement descriptions of the related-party transactions with LJM1 and LJM2 were factually correct, as far as they went. Nevertheless, it is difficult for a reader of the proxy statements to understand the nature of the transactions or their significance. The disclosures omit several important facts. The 2001 proxy, for example, refers to the sale by LJM2 of certain merchant investments to Enron in 2000 for $76 million. This disclosure, however, omits the fact that these transactions were buybacks of assets that Enron had sold to LJM2 the year before in what were described (in the prior year's proxy statement) as arm's-length transactions. And, while Enron contributions to the Raptor entities are mentioned, the document does not disclose that, by the terms of the deal, $82 million was distributed to LJM2 (and therefore to its partners) from Raptors I and II in 2000, even before those entities began derivative transactions with Enron. This last fact is of critical importance to any fair assessment of the transaction.

D. Financial Statement Footnote Disclosures

1. Enron's Disclosures

Enron included a footnote concerning "Related Party Transactions" to the financial statements in its reports on Forms 10-Q and 10-K beginning with the second quarter of 1999, when the transactions with the LJM partnerships began, through the second quarter of 2001. The disclosures in those footnotes fall into several categories.

Structure of LJM1 and LJM2. The description of LJM1 in the 10-Q for the second quarter of 1999 was similar to the one the Company used in the 2000 proxy statement, described above. The footnote said that "[a] senior officer of Enron is managing member of LJM's general partner." This footnote did not identify Fastow as the "senior officer of Enron," nor did the financial statement disclosure in any subsequent period. The disclosure also did not detail how LJM or Fastow would be compensated in the transactions, although it did say that "LJM agreed that the Enron officer would have no pecuniary interest in . . . Enron common shares and would be restricted from voting on matters related to such shares or to any future transactions with Enron." Substantially the same disclosures were made in the third quarter 10-Q and in the 1999 10-K.

The Company first described LJM2 in the 1999 10-K. Enron stated that "LJM2 Co-Investment, L.P. (LJM2) was formed in December 1999 as a private investment company which engages in acquiring or investing in primarily energy-related or communications-related businesses" and that LJM2 "has the same general partner as LJM[1]."

In the 10-Q for the second quarter of 2000, Enron described the LJM partnerships as follows: "In the first half of 2000, Enron entered into transactions with limited partnerships (the Related Party), whose general partner's managing member is a senior officer of Enron. The limited partners of the Related Party are unrelated to Enron." From the second quarter of 2000 forward, Enron did not identify LJM1 or LJM2 by name in the financial statement disclosures, using the generic term "Related Party" instead. This description was substantially unchanged until the second quarter of 2001, when the 10-Q reflected the sale of Fastow's interest in LJM by stating that "the senior officer,

who previously was the general partner of these partnerships, sold all of his financial interests as of July 31, 2001, and no longer has any management responsibilities for these entities" and that, "[a]ccordingly, such partnerships are no longer related parties to Enron."

In the 10-Qs for the first and second quarters of 2001, Enron represented that "[a]ll transactions with the Related Party are approved by Enron's senior risk officers as well as reviewed annually by the Board of Directors."

Descriptions of Transactions. Significant portions of the financial statement footnotes on related-party transactions were devoted to descriptions of transactions between Enron and the LJM partnerships.

Beginning with the 10-Q filed for the second quarter of 1999, Enron discussed the Rhythms transaction with LJM1 much as it did in the 2000 proxy statement. The disclosures identified the number of shares of stock and other instruments that changed hands; the description in the 1999 10-K removed the numbers of shares. In the 10-Q for the first quarter of 2000, the footnote described the April 2000 termination of the Rhythms transaction with a number of the transaction particulars.

Beginning with the 1999 10-K, Enron disclosed in each periodic filing that LJM1 and/or LJM2 acquired, directly or indirectly, merchant assets and other investments from Enron. These assets were not specifically identified in the disclosures; instead, Enron gave only the approximate dollar value of the assets, either individually or by groupings of similar transactions. We were told that Enron had a general corporate policy, not limited to related-party transactions, against identifying counter-parties in financial

statement footnotes. The Financial Reporting Group maintained backup materials to support the figures in the financial statement footnotes, and to identify the specific transactions that were covered by the related-party disclosures.

Enron introduced the first Raptor transactions in the 10-Q for the second quarter of 2000, and provided more detailed disclosures for all four Raptor vehicles in the 10-Q for the third quarter and in the 2000 10-K. These disclosures had two main parts: a fairly detailed description of the contributions Enron made to the Raptor Vehicles (referred to as the "Entities") at their creation, and a discussion of the derivative transactions between Enron and the Raptor Vehicles through which Enron sought to hedge certain merchant investments and other assets. In the third quarter 10-Q and the 10-K, Enron disclosed that it had recognized revenues of approximately $60 million and $500 million, respectively, related to the derivative transactions, which offset market value changes of certain merchant investments. (The 10-Qs for the first, second, and third quarters of 2001 included corresponding sets of disclosures.) The 10-Qs for the first and second quarters of 2001 identified instruments that the various parties to the Raptor restructuring transactions received.

Assertions That Transactions Were Arm's-Length. In each of the financial statement footnote disclosures concerning the transactions with LJM, Enron made a representation apparently designed to reassure investors that the transactions were fair to the Company. The language of this disclosure changed a number of times during the period at issue.

Enron stated in the 10-Q for the second and third quarters of 1999 that "[m]anagement believes that the terms of the transactions were reasonable and no less favorable than the terms of similar arrangements with unrelated third parties." The 10-K for 1999, however, removed the assertion that the transactions were "reasonable" and represented instead only that "the terms of the transactions with related parties are *representative of terms that would be negotiated* with unrelated third parties" (emphasis added). The reasonableness assertion reappeared in the disclosures for the first quarter of 2000, modifying the 1999 10-K version to read: "the terms of the transactions with related parties were reasonable and are representative of terms that would be negotiated with unrelated third parties." Enron used this formulation until the 10-K for 2000, which conditioned the assertion of reasonableness to claim only that "the transactions with the Related Party were reasonable *compared to those which could have been negotiated* with unrelated third parties" (emphasis added).

Although the paper trail details the iterations through which these management assertions passed during the drafting process, it is unclear who was responsible for the changes, or to what extent these changes were intended to reflect substantive differences in the characterizations of the transactions. We also do not know what steps Management or Andersen took to verify that the assertions were true before they were made. Handwritten notes next to the management assertion on drafts of the 1999 10-K read "need positive evidence" and "needs research."

We learned that some consideration was given to expanding the discussion of the fairness of the related-party transactions to Enron by describing certain advantages that had been identified at the time that Board approval was sought. Handwritten notes on

drafts of the 10-K for 2000 suggest adding that "transacting with the Related Party provides Enron with additional benefits related to the speed of execution and a counterparty who has a better understand[ing] of complex transactions." In the end, however, the drafters of the disclosures decided against including these or other similar reasons for the related-party transactions.

2. Adequacy of Disclosures

The financial statement footnote disclosures in the periodic reports were comparatively more detailed (except with respect to Fastow's interest in the transactions) than the proxy statement disclosures. Nevertheless, the footnote disclosures failed to achieve a fundamental objective: they did not communicate the essence of the transactions in a sufficiently clear fashion to enable a reader of the financial statements to understand what was going on. Even after months of investigation, and with access to Enron's information, we remain uncertain as to what transactions some of the disclosures refer. The footnotes also glossed over issues concerning the potential risks and returns of the transactions, their business purpose, accounting policies they implicated, and contingencies involved. In short, the volume of details that Enron provided in the financial statement footnotes did not compensate for the obtuseness of the overall disclosure. FAS Statement No. 57 required Enron to provide "[a] description of the transactions, . . . *and such other information deemed necessary to an understanding of the*

effects of the transactions on the financial statements" (emphasis added). We think that Enron's related-party transaction disclosures fell short of this goal.[86/]

Beyond this general point, our investigation found two particular problems with the related-party disclosures in the financial statement footnotes:

First, Enron lacked the factual basis required by the accounting literature to make the assertions in each SEC filing concerning how the LJM transactions compared to transactions with unrelated third parties. We were told by Enron officers and employees that they believed this management assertion to be *required* under the accounting literature. In fact, the accounting literature provides: "Transactions involving related parties *cannot* be presumed to be carried out on an arm's-length basis, as the requisite conditions of competitive, free-market dealings may not exist. Representations about transactions with related parties, if made, shall not imply that the related-party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions unless such representations can be substantiated." Statement of Financial

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86/ In June 2001, outside lawyers from the Fried, Frank firm, who had been asked by Mintz to look over the related-party transaction disclosures around the time of Fastow's sale of his interest in LJM2, reported the following concerning disclosure of LJM transactions: "Prior 10-Q disclosure appeared to leave some informational gaps, which were noted by those who commented on the Company's filings. We want to emphasize that we are not in a position to evaluate whether material information was omitted from the prior statements, and have not done so. However, from the standpoint of closing the discussion of these matters once and for all, we would consider supplementing the prior disclosures, where it is possible to do so, especially on such points as the purpose of the specific transactions entered into and the 'bottom-line' financial impact on the Company and the LJM partners."

Accounting Standards No. 57, ¶ 3 (emphasis added).[87] We have not been able to identify any steps taken by Enron Management, Andersen, or Vinson & Elkins to substantiate the assertions that the LJM transactions were "representative of" or "reasonable compared to" similar transactions with unrelated third parties—even though notes on some drafts refer to questions being raised about factual support for these representations.[88] Indeed, based on the terms of the deals, it seems likely that many of them could *only* have been entered into with related parties.

Second, the publicly filed financial statement disclosures omitted a number of key details about the transactions. For example, the Company disclosed in the 2000 10-K that "Enron paid $123 million to purchase share-settled options from the [Raptor] Entities on 21.7 million shares of Enron common stock." What it did not disclose, however, was that Enron purchased *puts* on Enron stock. It likely would have been relevant to investors that

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87/ Auditors are under an obligation not to agree to such disclosures without substantiation: "Except for routine transactions, it will generally not be possible to determine whether a particular transaction would have taken place if the parties had not been related, or, assuming it would have taken place, what the terms and manner of settlement would have been. Accordingly, it is difficult to substantiate representations that a transaction was consummated on terms equivalent to those that prevail in arm's-length transactions. If such a representation is included in the financial statements and the auditor believes that the representation is unsubstantiated by management, he or she should express a qualified or adverse opinion because of a departure from generally accepted accounting principles, depending on materiality . . . ." AICPA, Codification of Statements on Auditing Standards, § 334.12, Related Parties.

88/ The Fried, Frank review in June 2001 identified this issue as well, urging the company to identify what members of "management" had reviewed the transactions and what they had done. The firm also suggested to Mintz that the Audit and Compliance Committee, or a special committee of the Board appointed for this purpose, conduct "a review of the fairness of the terms of the transactions to the Company" to bolster the documentation for these representations. It does not appear that such a review was undertaken.

Enron had entered into a derivative transaction that was, on its face, predicated on the assumption that its stock price would decline substantially. Another example: Enron explained that the LJM partnerships bought merchant assets from Enron, but the footnote disclosures failed to mention that Enron repurchased some of these assets—sometimes within a matter of months, and sometimes before the periodic filing was made. No one interviewed in our inquiry could provide a plausible explanation why the repurchases from the related parties should not have been disclosed in the same manner as the original sales. It is fair to conclude that disclosure of the repurchases so close in time to the original transactions could have called the economic substance of the reported transactions with LJM into question.[89/]

E. Conclusions on Disclosure

Based on the foregoing information, the Committee has reached several general conclusions concerning the disclosures of related-party transactions in Enron's proxy statements and in the financial statement footnotes in the Company's periodic filings.

First, while it has been widely reported that the related-party transactions connected to Fastow involved "secret" partnerships and other SPEs, we believe that is not

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89 Enron explained in the 10-Q for the second quarter of 2001 that "the senior officer, who previously was the general partner of these [LJM] partnerships, sold all of his financial interests . . . and no longer has any management responsibilities for these entities." It did not disclose, however, that the interest was sold to Kopper, then a former employee of Enron, and therefore gave an impression that the interest would be held more independently from Enron than it was. We were told that Vinson & Elkins recommended disclosure of this fact, but that Enron's Investor Relations Department objected, and the Vinson & Elkins lawyers felt that they could not say it was legally required.

generally the case. Although Enron could have, and we believe in some respects should have, been more expansive under the governing standards in its descriptions of these entities and Enron's transactions with them, the fact remains that the LJM partnerships, the Raptor entities, and transactions between Enron and those entities all were disclosed to some extent in Enron's public filings.

Second, Enron's disclosures and the information we have about how they were drafted reflect a strong predisposition on the part of at least some in the Company to minimize the disclosures about the related-party transactions. Fastow made clear that he did not want his compensation from the LJM partnerships to be disclosed, and the process reflected a general effort to say as little as possible about these transactions. While we recognize that Enron was not alone in seeking to say as little as the law allowed, particularly on sensitive subjects, we were told by more than one person that the Company spent considerable time and effort working to say as little as possible about the LJM transactions in the disclosure documents. It also appears that Enron Management structured some transactions to avoid disclosure (such as the Chewco and Yosemite transactions described above). That impulse to avoid public exposure, coupled with the significance of the transactions for Enron's income statements and balance sheets, should have raised red flags for Senior Management, as well as for Enron's outside auditors and lawyers. Unfortunately, it apparently did not.

Third, the inadequate disclosures concerning the related-party transactions resulted, at least in part, from the fact that the process leading to those disclosures appears to have been driven by the officers and employees in Enron Global Finance, rather than by Senior Management with ultimate responsibility, in-house or outside

counsel, or the Audit and Compliance Committee. In fairness, the complexity of the transactions in question made it difficult for those not involved in their actual negotiation or structuring to have been sufficiently steeped in the details to allow for a complete understanding of the essence of what was involved. Nevertheless, the in-house and outside lawyers should have been familiar with the securities law disclosure requirements and should have exercised independent judgment about the appropriateness of the Company's statements. Causey was the Chief Accounting Officer and was specifically charged by the Board with reviewing Enron's transactions with the LJM partnerships. Causey should have been in a unique position to bring relative familiarity with the transactions to bear on the disclosures. The evidence we have seen suggests he did not. Similarly, the Audit and Compliance Committee reviewed the draft disclosures and had been charged by the Board with reviewing the related-party transactions. It appears, however, that none of these people independent of the Enron officers and employees responsible for the transactions provided forceful or effective oversight of the disclosure process.

Fourth, while we have not had the benefit of Andersen's position on a number of these issues, the evidence we have seen suggests Andersen accountants did not function as an effective check on the disclosure approach taken by the Company. Andersen was copied on drafts of the financial statement footnotes and the proxy statements, and we were told that it routinely provided comments on the related-party transaction disclosures in response. We also understand that the Andersen auditors closest to Enron Global Finance were involved in the drafting of at least some of the disclosures. An internal Andersen e-mail from February 2001 released in connection with recent Congressional

hearings suggests that Andersen may have had concerns about the disclosures of the related-party transactions in the financial statement footnotes. Andersen did not express such concerns to the Board. On the contrary, Andersen's engagement partner told the Audit and Compliance Committee just a week after the internal e-mail that, with respect to related-party transactions, "[r]equired disclosure [had been] reviewed for adequacy," and that Andersen would issue an unqualified audit opinion on the financial statements.

APPENDIX A

GLOSSARY

balance sheet

a financial report that shows the company's assets, liabilities, and shareholders' equity as of the close of a reporting period

call

an option that entitles the option holder to buy from the counter-party a commodity, financial instrument, or other asset at an exercise or strike price throughout the option term or at a fixed date in the future (the expiration date)

collar

a derivative transaction combining a put and a call (one written and one purchased) that effectively sets a limit on the gain and the loss that the holder of the contract will realize

consolidated financial statement

a financial statement that brings together all the assets, liabilities, and operating results of a parent company and its subsidiaries, as if the group were a single enterprise

cost method of accounting

an accounting method whereby an investor records an investment at the cost it paid, and does not record any gains or losses until receiving a distribution or disposing of that investment

costless collar

a collar in which the premiums payable on the put and the call equal one another, so neither party pays the other at the inception of the transaction

credit capacity

a counter-party's ability to meet its financial obligations

derivative

a contract whose value is based on the performance of an underlying financial asset, index, or other investment

equity method of accounting

an accounting method whereby an investor initially records an investment in an entity at cost and then, in contrast to the cost method of accounting, adjusts that amount to recognize its share of the entity's earnings or losses The investor does not recognize any gains or losses resulting from its transactions with the entity

fair value

the amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties

fairness opinion

professional judgment on the fairness of the price being offered in a transaction

Form 10-K

annual report filed with the Securities and Exchange Commission providing a comprehensive overview of the registrant's business and filed within 90 days after the end of the company's fiscal year

Form 10-Q

quarterly report filed with the Securities and Exchange Commission for each of the first three fiscal quarters of the company's fiscal year and due within 45 days of the close of the quarter

forward contract

a contract to purchase or sell a specific quantity of a commodity, currency, or financial instrument at a specified price with delivery and settlement at a specified future date

hedge

a strategy used to minimize price risk

income statement

a summary of the revenues, costs, and expenses of a company during an accounting period

in the money

a call option is in-the-money if the price of the underlying commodity, financial instrument, or other asset exceeds the strike or exercise price; a put option is in-the-money if the strike or exercise price exceeds the price of the underlying commodity, financial instrument, or other asset

joint venture

an enterprise owned and operated by a limited number of parties (the joint venturers) as a separate and specific business or project for their mutual benefit

merchant investment

an investment in a public or private equity, debt security, loan, or an interest in a limited partnership that is carried at fair value

notional value or notional amount

the face value of the underlying instrument on which a derivative is contracted

option premium

amount paid for the right to either buy or sell the underlying commodity, financial instrument, or other asset at a particular price within a certain time period

promissory note

written promise committing the party writing the note to pay the holder of the note a specified sum of money, either on demand or at a certain date, with or without interest

proxy statement

information that the Securities and Exchange Commission requires companies to provide to shareholders before they vote by proxy on company matters

put

an option that entitles the option holder to sell to the counter-party a commodity, financial instrument, or other asset at an exercise or strike price throughout the option term or at a fixed date in the future (the expiration date)

share-settled derivative

a derivative contract in which the party with a loss delivers to the party with a gain shares or units of the underlying commodity, financial instrument, or other asset

special purpose entity (or special purpose vehicle)

typically an entity created for a limited purpose, with a limited life and limited activities, and designed to benefit a single company

total return swap

an arrangement whereby one party agrees to pay the other party the appreciation from an asset and receive payments from the other party for the depreciation of an asset

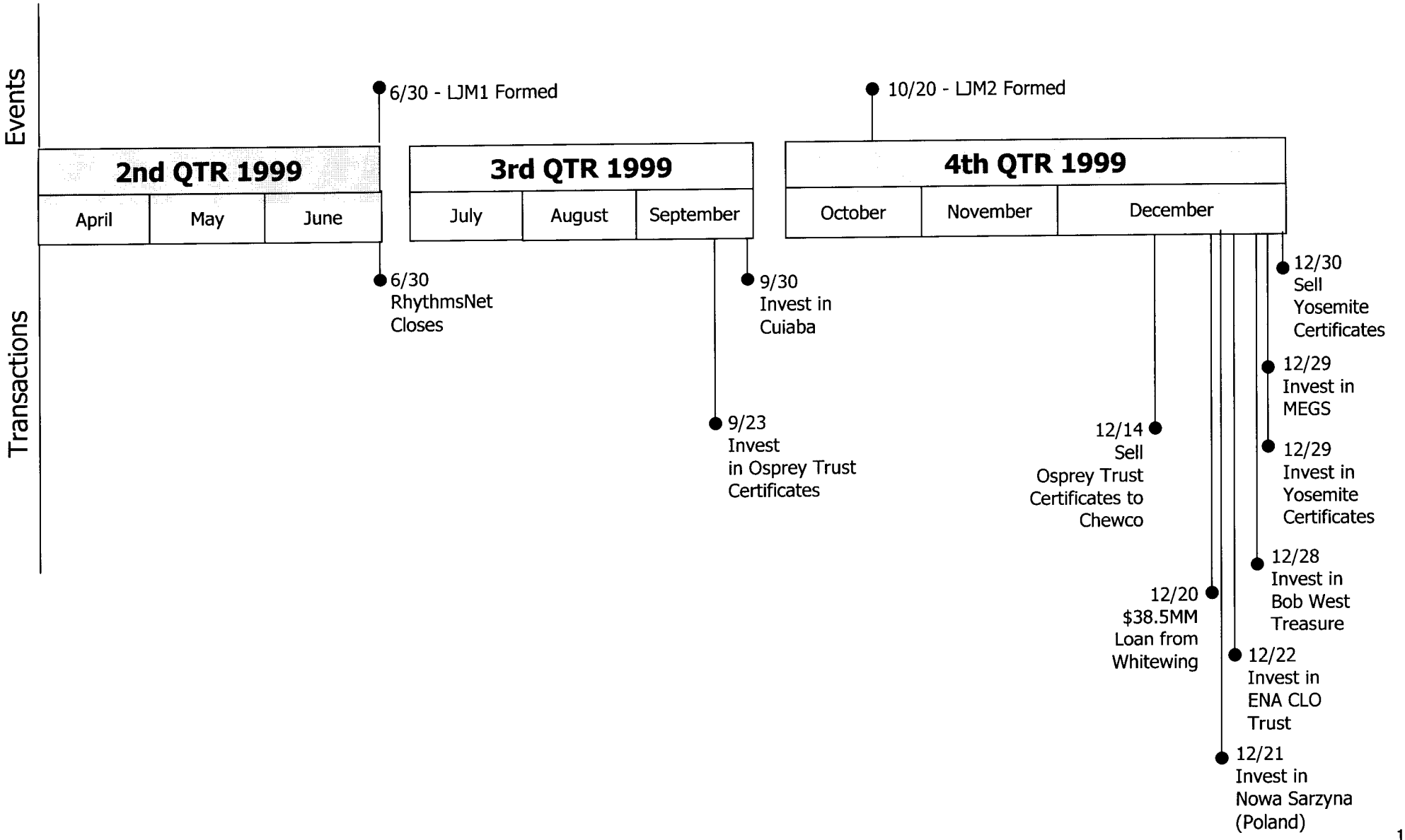
warrant

option to purchase a specified number of shares of stock at a stated price for a specific time period

APPENDIX B

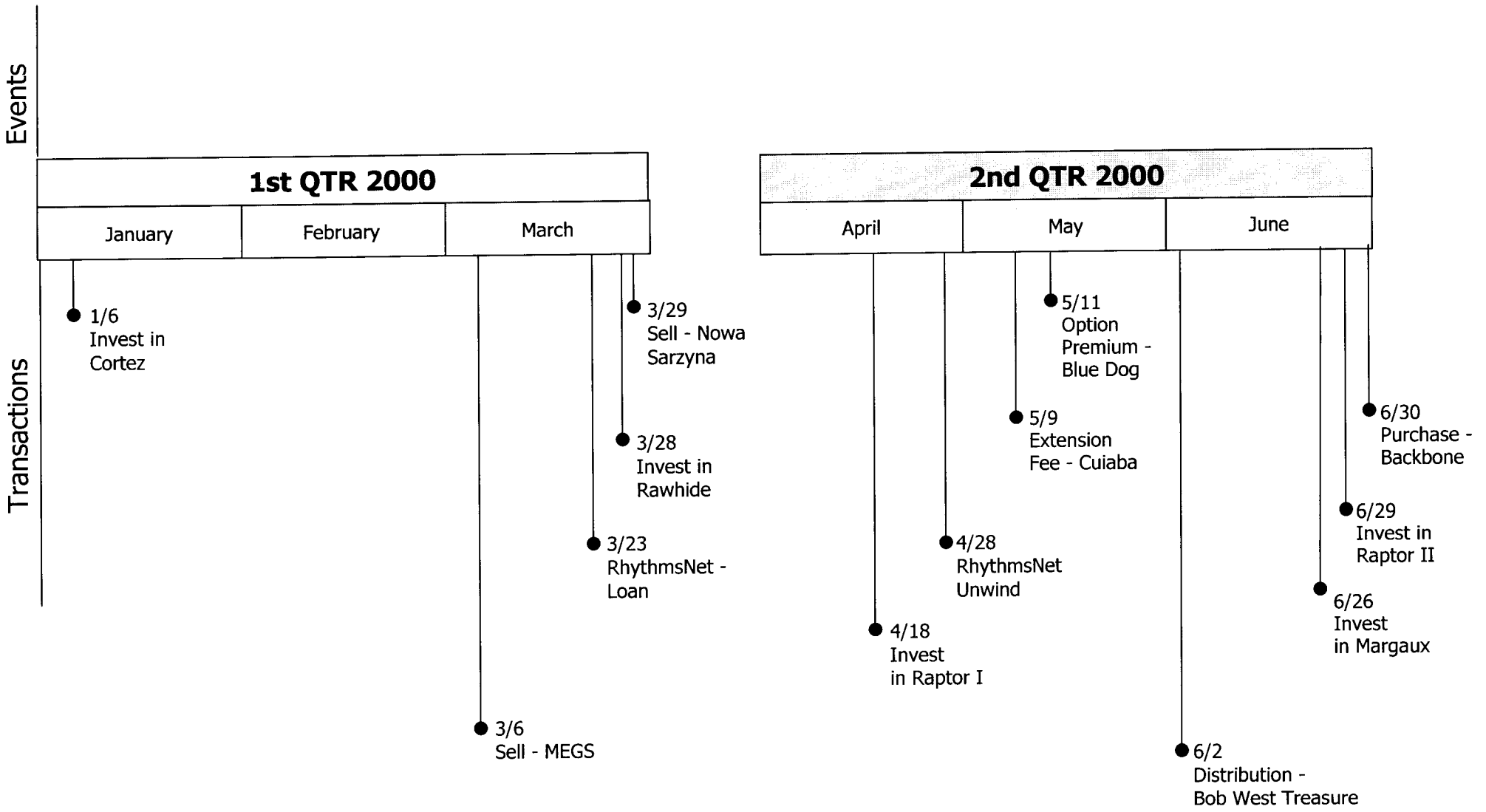
Timeline

June – December 1999



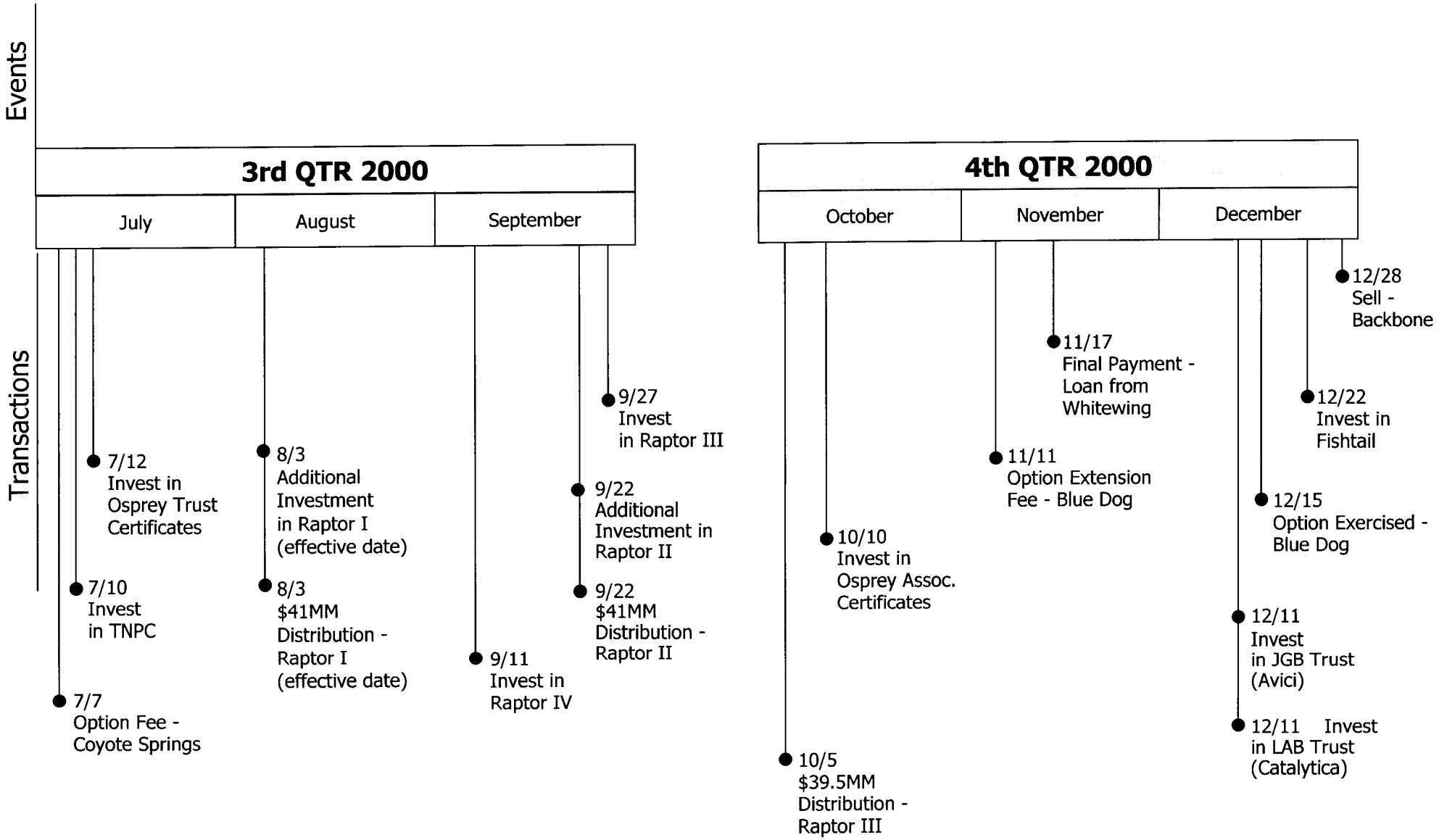
Timeline

January – June 2000



Timeline

July – December 2000



Timeline

January – December 2001